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SUBJECT: DESPITE ECONOMIC DIVERSIFICATION, BAHRAIN SHARES
OIL-BASED INFLATION PRESSURES WITH GCC

REF: A. MANAMA 44
¶B. MANAMA 76

¶1. (U) Summary: Although Bahrain's economy is not as dependent on petroleum exports as its GCC neighbors, it does feel similar inflationary pressures from rising oil prices. Bahrain's disproportionate susceptibility to petroleum-driven inflation is largely due to a combination of Central Bank policies, GOB fiscal policy--which is closely tied to oil revenues--and the strong inter-relation of the Bahraini economy with Saudi Arabia. Due to the diversification of its economy, Bahrain's inflation will likely remain the lowest in the Gulf, but upward pressures may push it far beyond recent expectations. End summary.

Background

¶2. (U) Unlike its GCC neighbors, petroleum and petroleum-related products account for less than 30% of Bahrain's GDP. Despite the smaller role oil appears to play in the overall economy, petroleum revenue accounts for almost 80% of Bahrain's central government revenue, which in turn was 25% of GDP in 2006. Bahrain derives its petroleum revenue from both onshore and offshore operations. Onshore oil production is relatively constant at about 182,000 barrels per day and does not appear to respond to price--this oil accounts for approximately 20% of all Bahrain's oil revenue. The remaining oil income is revenue from the joint Saudi-Bahraini offshore Abu Safa field. Saudi Arabia administers the field and provides Bahrain its share in cash--the amount of which remains undisclosed (ref A). Since Bahraini oil volumes do not appear to react to changes in the market, central government operating revenue is basically a direct function of oil price.

¶3. (SBU) Inflation figures for Bahrain vary widely. The Consumer Price Index (CPI)--determined by the GOB Central Informatics Organization (CIO)--has varied between 1.6% and 2.6% since 2003, while the GDP deflator, as reported in the International Monetary Fund's International Financial Statistics (IFS) has moved between 7.1% and 11%. Although both measurements of inflation have their weaknesses, the CPI is particularly suspect due to CIO's relative lack of ability to accurately measure inflation, lack of transparency in their calculations, and political pressures on the CIO to show low inflation rates. (Comment: The CIO's credibility is especially low with Bahrain's political opposition, who believe the CIO was caught red-handed under-reporting the number of Sunnis quietly naturalized in Bahrain (ref B). End comment.) The GDP deflator on the other hand, which simply measures the difference between the chain-volume measure of the GDP and the nominal change, misses the change in prices of imports into the economy, the value of which have not been below 60% of GDP as long as records have been kept.

¶4. (U) Regardless of the inflation measurement used,

inflation pressures not only increase as government revenues from oil increase, but also as oil revenues in Saudi and other GCC states increase, and those foreign funds find their way into the Bahraini economy. The level of effect that those GCC funds have on the Bahraini economy is largely dependent on the actions of the Central Bank.

Fiscal Policy) restraint limited?

¶5. (SBU) GOB spending historically accounts for approximately 25% of Bahrain's GDP. Out of fear of inflationary pressures, the GOB has generally exercised fiscal restraint. According to IFS data, while revenues, as a share of GDP, have grown by more than eight percent per year since 2005, government spending, as a share of GDP, has remained fairly constant and has even declined slightly. That restraint may have now reached its limit as there are growing demands for local infrastructure improvements and social programs. While projections from economic analysts such as Global Insights typically use assumptions that GOB spending will increase at approximately five percent per year, officials in Parliament and the Economic Development Board familiar with the 2008 draft budget indicate government spending may increase by as much as 20% in 2008, growing government spending to almost 30% of GDP.

Monetary Policy) loose control over M1

¶6. (U) The Central Bank of Bahrain (CBB) does not appear to actively attempt to sterilize foreign currency flows. According to IFS data, since 1990 the CBB has held foreign assets, as a share of GDP, fairly constant. Prior to 1990,

foreign assets fluctuated wildly in response to markets, reaching as high as 52% of GDP in 1986. By 2005, foreign assets were down to less than 17% of GDP, and have not fluctuated outside a range of 500 basis points since 1999. Prior to 1990, the government apparently offset foreign asset fluctuations with changes to central government deposit accounts--or quite simply, the government horded excess earnings to keep the money out of the economy. After 1990, as foreign asset holdings dropped and stabilized, central government deposits also dropped and stabilized, and there is no indication that the CBB issued bonds or other government securities to offset foreign assets. To further exacerbate the effects of not sterilizing, although not officially allowed, Saudi riyals circulate widely in Bahrain alongside the Bahraini dinar. Most retailers and service providers will accept riyals to settle accounts. As a result the CBB has only a loose control over the actual currency-used in circulation.

Close Saudi ties extend to inflation

¶7. (U) A sharp increase in the price of oil directly affects not only the balance sheet of Bahrain, but also that of its massive oil producing neighbor Saudi Arabia. Saudi Arabia has long-established commercial ties with Bahrain, and is Bahrain's primary trading and investment partner--when there is an increase in Saudi wealth, there is a corresponding increase in money spent in Bahrain. This money comes as both investment as well as direct consumption--Saudi Arabia accounts for more than one-quarter of Bahrain's tourism receipts, and more than five percent of its manufactured goods exports. With Saudi oil determining the GOB's operating budget, oil-derived investment funds driving the Bahraini real estate and financial markets, and Saudi cash being spent directly on the local service economy, movements in Bahraini inflation are likely to be highly correlated to those in Saudi Arabia. According to the Saudi Arabian Monetary Authority, inflation there is expected to exceed 10% in 2008.

Comment

¶8. (SBU) The diversification of Bahrain's economy away from petroleum has only partially insulated it from the inflationary pressures that the run up in oil has produced. The CBB's decision to not sterilize foreign assets, combined with growing social pressure to spend a larger portion of the oil-price windfall on domestic programs is putting stronger than expected upward pressure on inflation. As long as the economy of Bahrain is linked to Saudi Arabia, it will share in the benefits and trials that a volatile oil market may bring.

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